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EMORANDUM TO MEMBERS OF THE GOVERNOR'S
OMMITTEE ON TAX ADMINISTRATION:

I have given considerable thought to whether something more specific could be done at this time to implement the recommendation of the Subcommittee on Valuation, Allocation and Formulary Direct Pay regarding the promulgation by the Department of Revenue of regulations setting forth "the formulae employed by the Department in establishing valuations and any deviations therefrom as applied to particular industries."

I believe our Committee should strive to make some concrete recommendations to the Department of Revenue as to what form a formula may take which would substantially comprehend the formulae procedures now used and which could, if possible, be a fixed formula for all taxpayers producing substantially the same tax liabilities for taxpayers and the same revenues for the Commonwealth as at present.

This is obviously a difficult objective to obtain, but I believe the following suggestion for a formula approach might well reasonably attain this objective and I would like to submit it to the Committee for consideration.

I have concluded that the Massachusetts valuation formula, which is explained in the Subcommittee's report, cannot be employed

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in Pennsylvania without producing very substantial departures from present valuations and without causing unacceptable results for some industries. It appears to me, however, that the present practices of the Department, as I understand them, provide the basis for a formula approach which may well be applicable generally to all taxpayers. Thus, if the formula were to prescribe four of the factors variously used in developing the basis for a valuation under present practice and give the taxpayer the election each year to choose three of the four, I believe that the valuations produced by such a formula approach would not vary unduly from present valuations. The four factors, from which the taxpayer could elect any three in each year, and determine his valuation by averaging the three factors, would be as follows:

(1) The average of the taxable year's and the previous four years' net income capitalized at 10%;

(2) The average of the taxable year's and the previous four years' dividends capitalized at 8%;

(3) The average of net worth at the beginning and the end of the taxable year;

(4) The average of the closing market quotations of the stock of the company at the end of the five consecutive quarters including those quarters ending at the beginning and end of the taxable year.

It is assumed that the fourth factor would be elected

only in unusual circumstances, such as in the case of the railroads where the stock is selling below book value. But this factor, which is generally given little if any consideration in most cases, is needed by some taxpayers and industries in order to have valuations approaching those now prevailing. In a case where the fourth factor is used, however, it is likely that the valuation determined from earnings and dividends might be even less and it would be appropriate, therefore, to provide that if the fourth factor is one of the factors used, the value should in no case be less than the market value of the stock.

It must also be recognized that any formula will at least in some cases result in an unreasonable valuation and, accordingly, either the Department of Revenue or the taxpayer should have the right to make a departure from the formula where a more reasonable value than is produced by the formula can be demonstrated. But it is important that the formula valuation be presumptively correct and if the Department of Revenue seeks a departure from the formula it must carry the burden of proof in support of a different value, just as the taxpayer would have the burden of proof where he wishes to make a departure from the formula.

In order to assure that taxpayers are not unduly benefited or burdened and that the revenues are not unduly diminished or enhanced by the shift from the present negotiated valuation to the

formula valuation, I suggest that the formula valuation be implemented over a transition period of five or perhaps ten years. Thus, the valuation in the transition period would be the taxpayer's valuation last determined under current practice, say for the year 1962, and there would be added or subtracted one-fifth (or one-tenth) of the difference between such valuation and the valuation determined under the formula in the first year, two-fifths (or two-tenths) in the second year and so forth until the valuation is based wholly on the formula.

The first year of the transition period would produce the statistics needed to determine what effect the formula was having. Thus, before its effect would be very great appropriate adjustments in the capital stock tax rate or in the formula could be made.

The gradualness of such an approach would prevent serious distortion but at the same time would achieve the objective of putting valuation on a fixed basis rather than on a negotiated basis, which is the main objective of a formula approach.

There might be a question as to whether the Department of Revenue can under the present law adopt regulations effectuating the foregoing suggestions and this should be given further consideration. If this approach cannot be effectuated under present law and the Committee believes that it is a sound approach,

the Committee could recommend that it be implemented through legislation.

I hope we can discuss this approach in connection with our consideration of the report of the Subcommittee on Valuation, Allocation and Formulary Direct Pay.

L. E. Kust, Chairman
The Governor's Committee
on Tax Administration